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SUBJECT: DOMINICAN CAPITAL MARKET FAILS TO DEVELOP

¶1. (SBU) Summary: Business finance in the Dominican Republic remains opaque, dominated by a small number of banks and trading groups characterized by virtually incestuous relationships. The country's long history of crony capitalism, corruption and tax evasion has retarded the establishment of modern practices of bookkeeping and of public trading of stocks, bonds and commercial paper. Despite extensive USG investment in technical assistance for a Dominican securities exchange, virtually all secondary trades are done outside that institution by bank offices on own account, exploiting lack of information to rack up large profits. It is virtually certain that much of the business is tied to money laundering of some sort or other. End summary.

¶2. (SBU) The Dominican private sector has evolved only very minimally away from oligarchic business structures that originated in the 30-year Trujillo dictatorship and were reinforced by the influence-peddling and corruption characteristic under the autocratic Balaguer (1966-1976 and 1984-1996). Banking regulation was slack enough to open the way for the catastrophic bank collapses of 2003, due mostly to fraud and to unsupervised lending to associated industrial groups. The IMF standby, signed in 2003 but effective only from early 2005, provided the suasion for notable strengthening of bank regulation; it did not, for example, prevent the executive president of Banco de Progreso from issuing more than \$200 million in unbacked commercial paper and pocketing the proceeds, an operation discovered by shareholders in late 2005.

¶3. (SBU) Business finance in the Dominican Republic remains opaque, dominated by a small number of banks and trading groups characterized by virtually incestuous relationships. The country's long history of crony capitalism, corruption and tax evasion has retarded the establishment of modern practices of bookkeeping and of public trading of stocks, bonds and commercial paper. During the first Fernandez administration (1996-2000) USAID identified the need for a public market in securities. Associated with the notion of financial "deepening," the proposal was to help create conditions for trading an array of private- and public-sector financial instruments. This market would disclose prices of trades, providing market discipline for companies and obliging them to provide ample information about their operations. Between 1997 and 2004 USAID invested almost USD 2 million in the undertaking. Efforts included technical assistance to develop the Santo Domingo Securities Exchange (Bolsa de Valores) and assistance in drafting new legislation on capital markets, passed in 2000, as well as supporting regulations. USAID financed the purchase of software for trades and for tracking the market.

14. (SBU) Despite these efforts, today the Bolsa de Valores sits almost idle. President of the Bolsa Marino Ginebra, also a successful entrepreneur, recently told reporters that the country "lacks the culture necessary to support a properly functioning capital market." Perhaps; but this is demonstrated also by the fact that the market's regulatory body, the Securities Commission (Superintendencia de Valores or SIV), has never sanctioned the failure to respect provisions of Law 19-00 and Reglamento 729-04 that require trades to be registered and carried out through the Bolsa. The Commission accommodates the cronyism of Dominican finances. Sovereign bonds, Central Bank certificates of deposit and commercial paper are not issued through the Bolsa or traded there, with few exceptions. Original issues are generally sold directly to the public by the issuing companies and institutions.

15. (SBU) The secondary market in these instruments completely bypasses the Bolsa. These trades are typically accommodated by offices of commercial banks labeled "exchange trading seats" ("puestos de bolsa") but acting with no regard for the Bolsa. Trades are not registered with the Bolsa and

the trading prices are not published. The bank offices do not register the identity of the buyer or seller. Further, the trades carried out by the "exchange trading seats" are non-transparent and inefficient, in effect obliging sellers to accept whatever rate the office is willing to pay. This often means a substantial discount. Banks comfortably rack up profits from their advantage in information about the market and the issuers of commercial paper.

16. (U) Twelve such trading offices are registered with the Securities Commission (SIV). Some but not all are located on the affiliated bank's property and closely integrated with the bank's treasury operations. Not surprisingly, several more firms or entrepreneurs have applied to the SIV to operate such offices.

17. (SBU) The lack of transparency and the flouting of the requirement to register trades creates an opportunity for money laundering. This is one explanation why some bondholders, for instance, are willing to trade through the "puestos," receiving as little as 50 percent of the face value of the bond. It also explains why banks, despite their declarations of support for enforcing use of the Bolsa, are perfectly happy for business to continue as usual through their "puestos de bolsa." There are plenty of anonymous traders out there keeping the funds flowing through the banks. If the government were to begin forcing all trades to be registered and to pass through the Bolsa, some of the current business would disappear -- but we do not know how much.

18. (U) Companies in the Dominican Republic historically have not published financial statements; this is because almost without exception they are not publicly traded. Bolsa President Ginebra accepts this as a given: "They don't want competitors to know details of their business." Another reason is that typically companies are operating accounting systems that misrepresent financial results in order to minimize tax obligations.

19. (SBU) Dominican customs authorities and income tax authorities have made considerable progress in detecting frauds and raising government revenues. But deception and poor practice in business finance and trading are so ingrained and widespread that most businesses consider it more financially prudent to hide and to cheat than to comply.

The permissive atmosphere of the current Fernandez administration, especially toward large firms, does nothing to change this view. Prospects for financial modernization of Dominican business remain poor and will not change appreciably unless regulators and tax authorities start to take on some of the bigger firms. But all of them have contributed to Fernandez and his party -- as well as to any other political party with electoral prospects.

HERTELL